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CHARLES ELMORE

No. 334

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1930

HANS REES' SONS, INC.

Appellant

v.

STATE OF NORTH CAROLINA, on the Relation of ALLEN J. MAXWELL, Commissioner of Revenue

Respondent

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF NORTH CAROLINA.

BRIEF AND ARGUMENT FOR APPELLANT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1930.

HANS REES' SONS, INC.,
Appellant,

v.

STATE OF NORTH CAROLINA, on the Relation of Allen J. Maxwell, Commissioner of Revenue,
Respondent.

No. 334.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF NORTH CAROLINA.

Reference to Report Below.

The opinion of the State Supreme Court is reported as *Maxwell, Commissioner of Revenue* v. *Hans Rees' Sons, Inc.*, 199 N. C. 42. The same case is also reported in 153 S. E. Rep., 850.

No opinion was written in the Superior Court of Buncombe County, where the case originated.

Statement of Jurisdiction.

In accordance with Rule XII, the appellant duly filed a statement showing the jurisdiction of this Court. Consideration of jurisdiction was reserved until the argument of the case on the merits. Appellant submits here a summary statement of the jurisdiction of this Court, supplementing the statement heretofore filed.

The jurisdiction of this Court is invoked under Section 237 (a) of the Judicial Code, as amended by Act of February 13, 1925, Chapter 229, 43 Stat. 937, U. S. Code, Ann. Title 28, Section 344, and under Sections 861 (a) and (b), U. S. C. A., being the Acts of January 31, 1928, Chapter 14, §1, 45 Stat. 54, and of January 31, 1928, Chapter 14, §2, 45 Stat. 54, as amended April 26, 1928, Chapter 440, 45 Stat. 466.

The judgment of the Supreme Court of North Carolina is a final judgment in a suit under Article IV, Sections 2 and 8, of the Constitution of the State of North Carolina, and Sections 615, 658, 659, 1412 and 1413 of the North Carolina Code. *Chavis* v. *Brown*, 174 N. C. 122.

The judgment sought to be reviewed was entered in the Supreme Court of the State of North Carolina on the 16th day of June, 1930 (R. 166).

The petition for appeal (R. 167), the assignment of errors (R. 167) and the prayer for reversal (R. 169) were presented to the Chief Justice of the Supreme Court of the State of North Carolina on the 18th day of July, 1930; and the order allowing said appeal (R. 169) was issued, and the appeal bond approved by him on the said 18th day of July, 1930. The citation on appeal was signed by him on the 18th day of July, 1930, and was served upon the appellee on the 25th day of July, 1930.

The case was brought by appellant, a New York corporation, to recover income taxes imposed by the State of North Carolina. Throughout the entire proceeding appellant has based its claim of right to recover in this case upon the ground that the North Carolina statute, as construed and enforced against appellant, was repugnant to the Commerce Clause and the Fourteenth Amendment of the Federal Constitution.

Taxes for the years 1923, 1924, 1925, and 1926, are involved. The statute provides an allocation of income on the basis of the location of tangible property and has been construed to allocate to North Carolina and subject to tax by that State an average of 80% of appellant's total net income. Appellant contends that only 17% of this income in fact had its source in the operations in North Carolina, and that a statute construed to impose a tax on more than four times the proportion of income of a foreign corporation actually having its source in the State is invalid.

The facts as to the source of appellant's income are set out at length (*infra*) in Point I (p. 18). The State Court struck out all of appellant's evidence as to the character of its business and the sources of its income as immaterial. The legal effect of this ruling on the constitutional questions involved is discussed (*infra*) Point II (p. 33).

The constitutionality of the statute, construed to tax 80% of income, while only 17% had its source in the State, is discussed (*infra*) Points III-V (pp. 51-76).

To sustain the jurisdiction of this Court, appellant contends:

> *First.*—The judgment appealed from is a final judgment of the Supreme Court of North Carolina, which is the highest court in the State having jurisdiction of the case. The case drew in question

the validity, under the Federal Constitution, of the statute of North Carolina imposing the taxes in question, and the judgment of the State Court upheld the validity of the statute.

Second.—The statute of North Carolina has been construed to impose a tax upon 80% of appellant's income, while in fact only 17% of its income was derived from business or operations in the State of North Carolina. The statute as so construed is repugnant to the Federal Constitution.

Third.—The unconstitutionality of a state tax statute cannot be affected by a ruling of the State Court that evidence showing the unjust operation of the statute is immaterial.

The following decisions of this Court are believed to sustain jurisdiction of this appeal:

Fisk v. *Kansas*, 274 U. S. 380, 385;
Dahnke-Walker Milling Co. v. *Bondurant*, 257 U. S. 282;
Cudahy Co. v. *Parramore*, 263 U. S. 418, 422;
Kansas City So. Ry. Co. v. *Road Improvement Dist.*, 266 U. S. 379, 385;
Nashville, Chattanooga & St. Louis Ry. v. *White*, 278 U. S. 456;
Safe Deposit & Trust Co. of Baltimore v. *Virginia*, 280 U. S. 83.

Statement of Case.

This is an appeal from a final judgment of the Supreme Court of the State of North Carolina, affirming the judgment of the Superior Court for Buncombe County, entered after a trial before the Court, without a jury.

The action was brought to recover taxes assessed under the North Carolina income tax laws of 1923 and 1925, on the ground that said laws as construed and applied to the appellant were repugnant to the Federal Constitution. The appellant filed returns and paid certain taxes shown to be due thereon for the years 1923, 1924, and 1925, voluntarily and without protest. Thereafter, the Commissioner of Revenue audited the returns for these three years, and assessed additional taxes. The appellant paid these additional taxes for these three years and the entire taxes for 1926 under protest, and thereafter took an appeal for the recovery of the entire taxes paid for the four years.

As to the taxes paid without protest appellant acquiesces in the decision of the State Court that recovery is barred through failure to protest (R. 166). As to the taxes paid under protest it is not questioned that appellant has exhausted by due and timely proceedings all the legal and administrative remedies provided by the state statutes and procedure. There is no technical question of procedure. The sole question is whether these taxes were illegally assessed and collected. The taxes paid under protest are as follows:

For the year 1923	$2,124.65
" " " 1924	1,536.77
" " " 1925	444.11
" " " 1926	3,651.46
A total of	$7,756.99

The taxes for 1923 and 1924 were assessed under Section 201, Chapter 4, of the Public Laws of 1923 of North Carolina; and the taxes for 1925 and 1926 were assessed under Section 201, Chapter 101 of the Public Laws of 1925 of North Carolina. The statutes are printed in the margin. (1)

The statutes provide for an apportionment of income on the inflexible basis of location of tangible property owned. All other factors are disregarded. This case presents the question, heretofore expressly left undecided by this Court, whether such a statute is arbitrary and unconstitutional when the record shows that it results in fact in an unreasonable and unjust tax, and imposes a burden upon a much larger percentage of income than in fact had its source in the State.

Appellant is a New York corporation, having its principal office in New York City, where is located its sole sales office and where it also rents and operates a factory and warehouse. It also owns and operates a tannery in Asheville, North Carolina. Most of its manufacturing is done in North Carolina. All of its selling, all of its financial operations, and a part of its manufacturing are con-

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(1) SEC. 201 OF CHAP. 4, OF THE LAWS OF 1923.

"Every corporation organized under the laws of this state shall pay annually an income tax, equivalent to three per cent of the entire net income as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this state shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income to be determined according to the following rules:

"In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this state on the date of the close of the fiscal year of such company in the income year is to the fair cash

ducted in New York. The appellant does not deny that the State of North Carolina has jurisdiction to impose an income tax against it for that portion of its total income which was derived from its operations in North Carolina. The question presented by this appeal is whether the statutory rule for the apportionment of income, as it has been construed and applied to the appellant, is repugnant to the Fourteenth Amendment and the Commerce Clause of Section 8 of Article One of the Federal Constitution.

There is no dispute as to the amount of appellant's gross or net income nor that the computation of the tax was made in conformity to the statute.

Applying the statute, the North Carolina authorities have apportioned an average of eighty per cent. (80%) of the corporation's income as having its source in North Carolina, and have imposed a tax upon that amount of income. The appellant contends that only an average of

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value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

"In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this state for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the state."

SEC. 201 OF CHAP. 101 OF THE LAWS OF 1925.

"Every corporation organized under the laws of this state shall pay annually an income tax, equivalent to four per cent of the entire net income as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this state shall pay annually an income tax equivalent to four per cent of a proportion of its entire income to be determined according to the following rules:

"(a) In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale or rental of real estate or from the manufacture, purchase, sale of, trading in, or use of tangible (personal) property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this state on

seventeen per cent. (17%) of its income had its source in the company's operations in North Carolina, that the remainder of the income was derived from operations without the State, and that therefore the application of the statutory rule of apportionment to it is arbitrary and repugnant to the Constitution.[2]

At the trial in the Superior Court appellant introduced evidence, without objection as to its form or competency, showing the nature and character of its business, and an analysis of its accounts and the sources of its profits in support of its contention that only 17% of its income was derived from North Carolina sources, or was subject to tax by that State (R. 94-151). At the conclusion of the case the trial court struck out all of appellant's evidence as immaterial, and holding that the statute was not unconstitutional on its face, gave judgment against the appellant (R. 151). This excluded evidence is embodied in

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the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deductions on account of incumbrances thereon.

"(b) In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this state for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the state.

"(c) The words 'tangible personal property' shall be taken to mean corporeal personal property, such as machinery, tools, implements, goods, wares and merchandise and shall not be taken to mean money deposits in bank, shares of stock, bonds, notes, credits or evidence of an interest in property and evidences of debt."

(d) (Relating to foreign insurance companies, omitted.)

[2] The original petition for review alleged that less than 25% of the income had its source in North Carolina. Appellant's direct evidence was to the effect that only 17% had its source in that State. Upon another theory of computation, 21.7% of the income was derived from North Carolina operations. In its opinion the State Supreme Court assumed that the evidence established 17%.

the record before the State Supreme Court and in the record on appeal here. In the State Supreme Court the action of the trial court in striking out all of appellant's evidence as immaterial was urged as error, upon the ground that the constitutionality of the statute could only be determined in the light of its practical application to appellant (R. 152).

The State Supreme Court held that the statute was not unconstitutional on its face (R. 161); and assuming that the excluded evidence established that only 17% of the income in fact had its source in the operations in North Carolina (R. 164), held the exclusion of that evidence was not error (R. 165), apparently upon the ground that in view of the general character of appellant's business, evidence showing that the statutory apportionment resulted in an unjust tax in fact was not admissible.

The constitutional question presented on this appeal, therefore, is whether a state statute construed to impose a tax upon 80% of a foreign corporation's income, when in fact only 17% of its income is derived from operations in that state, is valid. Affecting this constitutional question is the primary question, whether appellant's evidence established in fact that the statutory allocation of income was arbitrary and unreasonable as applied to it, and the procedural question as to whether it was error to strike out this evidence as immaterial.

Specification of Errors.

1. The Supreme Court of the State of North Carolina erred in refusing to find Section 201, Chapter 4 of the Public Laws of North Carolina, Session of 1923, and Section 201, Chapter 101 of the Public Laws of North Carolina, Session of 1925, unconstitutional and repugnant to Section one of the Fourteenth Amendment to the Constitution of the United States, because, as construed and applied to this appellant, they result in a taking of its property without due process of law and deprive it of the equal protection of the laws by imposing arbitrary and unreasonable taxes on it.

2. The Supreme Court of the State of North Carolina erred in refusing to find Section 201, Chapter 4 of the Public Laws of North Carolina, Session of 1923, and Section 201, Chapter 101 of the Public Laws of North Carolina, Session of 1925, unconstitutional and repugnant to the Commerce Clause of Section 8 of Article I of the Constitution of the United States, because, as construed and applied to appellant, they result in the imposition of a tax which is an invalid burden upon appellant's interstate commerce.

3. The Supreme Court of North Carolina erred in holding the taxes imposed upon appellant were constitutional and were not repugnant to the Commerce Clause of Section 8 of Article I and Section One of the Fourteenth Amendment to the Constitution of the United States.

4. The Supreme Court of the State of North Carolina erred in affirming the judgment of the Superior Court, and in refusing to reverse said judgment upon the ground

that said Superior Court erred in striking out all of appellant's evidence as to the character of its business and the sources of its income as immaterial.

5. The Supreme Court of the State of North Carolina erred in holding that, although appellant had been taxed on 80% of its income, evidence tending to show that only 17% of its income came from its operations in North Carolina was immaterial.

6. The Supreme Court of the State of North Carolina erred in rendering the final judgment or decree against the appellant upon the 16th day of June, 1930, in the above entitled cause.

Summary of Argument.

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1. The record, including the evidence stricken out as immaterial, shows that in fact the taxes assessed on appellant are unjust and that an unreasonable part of its income has been apportioned as having its source in North Carolina 18

2. The order striking from the record as immaterial all of appellant's evidence was reversible error ... 33

(a) A taxpayer who questions the constitutionality of a taxing statute must show the application of the statute to himself, and that it operates unjustly as to him. In the absence of such showing, the Court will decline to consider the constitutionality of the statute. Therefore, evidence showing the facts of appellant's business and the unfair application of the statute to it was not immaterial, but was a necessary part of appellant's case. The order striking out that evidence was error.

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113;

American Manufacturing Co. v. *St. Louis*, 250 U. S. 459;

Dahnke-Walker Milling Co. v. *Bondurant*, 257 U. S. 282.

(b) Whether such error was a sufficient ground for reversal depends upon whether it might have changed the result of the case.

Judicial Code, 269; 28 U. S. C. A. 391;

Liberty Oil Co. v. *Condon Bank*, 260 U. S. 235;

Camp v. *Gress*, 250 U. S. 308.

(c) The State Court has misapprehended the "unity of use" or "unified business" rule as applied by this Court. It is not an arbitrary

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rule to sustain the constitutionality of state statutes, but is an application of the familiar rule that tax questions are determined on matters of substance and not of form.

Fargo v. *Hart*, 193 U. S. 490;
Oklahoma v. *Wells Fargo*, 223 U. S. 298;
Illinois Central R. R. v. *Greene*, 244 U. S. 555;
Union Tank Line v. *Wright*, 249 U. S. 275;
Southern Railway v. *Kentucky*, 274 U. S. 76;
Adams Express Co. v. *Ohio*, 165 U. S. 194;
Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113;
Bass, Ratcliff & Gretton v. *State Tax Commission*, 266 U. S. 271.

(d) The exclusion of evidence showing that in fact only 17% of appellant's income came from sources in North Carolina was reversible error.

3. On the merits, the statute, construed as imposing a tax on 80% of appellant's income, while in fact only 17% of the income is earned in the State, is unconstitutional because:

(a) It is repugnant to the due process clause of the Fourteenth Amendment 51

(1) Taxation by a state of persons, property or business without its taxing jurisdiction is invalid under the due process clause.

State Tax on Foreign Held Bonds, 15 Wall. 300;
New York, Lake Erie & Western v. *Pa.*, 153 U. S. 628;
Union Refrigerator Transit Co. v. *Kentucky*, 199 U. S. 194;
Union Tank Line v. *Wright*, 249 U. S. 275;
Oklahoma v. *Wells Fargo*, 223 U. S. 298.

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(2) An income tax is no exception to this rule. As to it there must be jurisdiction to tax either the recipient or the source.

State Tax on Foreign Held Bonds, 15 Wall. 300;
Alpha Portland Cement Co. v. *Mass.*, 268 U. S. 203;
Shaffer v. *Carter*, 252 U. S. 37;
St. Louis v. *Ferry Co.*, 11 Wall. 423.

(3) North Carolina has no personal jurisdiction over appellant, a foreign corporation, and its jurisdiction to impose an income tax against appellant rests upon jurisdiction to tax the source of the income. Necessarily, therefore, jurisdiction to impose an income tax is limited to that part of the income which has its source in the taxing state.

Shaffer v. *Carter*, 252 U. S. 37;
The Yale and Towne Mfg. Co. v. *Travis*, 252 U. S. 60.

(4) A statutory allocation of income which is arbitrary and likely to subject to tax income which does not have its source in the State is invalid as to a corporation which is in fact unjustly taxed.

Gast Realty Co. v. *Schneider Granite Co.*, 240 U. S. 55, 59.

(5) The North Carolina statute allocates income on the location of tangible property owned, and disregards all other factors affecting the source of income such as the location of tangible property used but rented and not owned and the location of intangible property and the character of use.

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In former cases this Court has declined to decide whether such an allocation is arbitrary and invalid upon the ground that the taxpayer had failed to show that the statute in fact worked an unjust result as to him.

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113;

Bass Ratcliff & Gretton v. *State Tax Commission*, 266 U. S. 271.

(6) The arbitrary character of the statute appears from the fact that:

It taxes 80% of the income when only 17% came from the State.

It includes dividends and interest received from sources without the State in the total of apportionable income, but excludes the capital value of these securities in the apportionment of assets thus directly subjecting to tax income that is without the jurisdiction of the State.

If doing the same business appellant owned its New York factory and rented its North Carolina factory the income allocated to North Carolina would be decreased 50%.

It ignores the fact that the major part of appellant's profits come from a retail merchandising business conducted from the New York office.

It is contrary to general business experience in its assumption that profits are directly or chiefly dependent on the physical location of tangible property.

(b) It is repugnant to the Commerce Clause of Section One of the Constitution 68

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A State cannot impose a tax which is a direct burden upon interstate commerce.

Crew Levick Co. v. *Penn.*, 245 U. S. 292;
Kansas City Ry. Co. v. *Botkin*, 240 U. S. 227;
U. S. Express Co. v. *Minnesota*, 223 U. S. 335;
Galveston Railway Co. v. *Texas*, 210 U. S. 217.

A State having personal jurisdiction over a taxpayer can impose a general income tax on him including in the measure of the tax income derived from interstate commerce.

U. S. Glue Co. v. *Oak Creek*, 247 U. S. 321;
Peck & Co. v. *Lowe*, 247 U. S. 165.

But where a State's tax jurisdiction is based on jurisdiction over the source a tax on income not having its source in the State but in foreign and interstate commerce is a direct burden on such commerce and is invalid under the commerce clause.

Alpha Portland Cement Co. v. *Mass.*, 268 U. S. 203;
International Paper Co. v. *Mass.*, 246 U. S. 135;
Looney v. *Crane*, 245 U. S. 178;
Fargo v. *Hart*, 193 U. S. 490;
Oklahoma v. *Wells Fargo Co.*, 223 U. S. 298;
Pollock v. *Farmers Loan & Trust Co.*, 157 U. S. 429; 158 U. S. 601.

(c) It is repugnant to the equal protection clause of the Fourteenth Amendment 71

The statute makes an arbitrary classification of corporations. The income of those

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dealing in tangible property is allocated on one basis, and that of those dealing in other property on another basis. This classification has no reasonable basis and as to those that suffer thereby the statute is invalid under the equal protection clause of the Fourteenth Amendment.

Gast Realty Co. v. *Schneider Granite Co.*, 240 U. S. 55;

Air-Way Elec. Co. v. *Day*, 266 U. S. 71;

Louisville Gas & Electric Co. v. *Coleman*, 277 U. S. 32;

Quaker City Cab Co. v. *Pennsylvania*, 277 U. S. 389.

ARGUMENT.

POINT I.

The record, including the evidence stricken out as immaterial, shows that in fact the taxes assessed on appellant are unjust, and that an unreasonable part of its income has been apportioned as having its source in North Carolina.

Appellant's total net income and the amounts apportioned to its North Carolina operations under the statutory rule are as follows (R. 15, 16, 32):

Year	Total Net Income	Net Income Apportioned to North Carolina	Total Tax	Percentage of Total Income Taxed
1923	$231,927.90	$194,123.65	$5,823.61	83.7
1924	257,881.70	221,494.59	6,644.84	85.89
1925	146,561.43	97,217.13	3,888.64	66.32
1926	106,727.55	91,286.49	3,651.46	85.53226
Average percentage taxed by North Carolina ...				80.38

The evidence which appellant contends establishes in fact that only 17% of its income was derived from North Carolina sources is summarized as follows:

Appellant is a New York corporation. Its business is that of tanning and manufacturing and selling leather. Its headquarters are in New York City, where it maintains its executive offices, sales offices, a cutting plant, a manufacturing plant, and warehouses (R. 97-100, 102, 103, 109, 110, 118). The New York real estate is rented and not owned (R. 145-151). It owns and operates a tannery at Asheville, North Carolina (R. 96). It also owns some timber land in North Carolina, carried at a value of $40,000 on its books, which is held as a reserve bark supply.

No use was made of this land during the years in question, and its ownership represented entirely an expense item for taxes and foresters (R. 97-98). Its bank accounts in New York average from $50,000 to $100,000. Its bank accounts in North Carolina average from $2,000 to $3,000.

The company owns stock in two corporations having no relation to North Carolina valued at $24,500 (in 1926 it was $27,200) (R. pp. 14, 21, 23, 29, 30). It received dividends on these stocks amouting to $904 in 1923 and 1924, and $804 in 1926 (R. pp. 10, 18, 32). These dividends were included in total apportionable net income, but the value of the stocks was disregarded in the allocation of assets. In 1926 it also received interest of $1,796.63 (p. 32) which was included in total taxable income although the securities producing the income were excluded in the allocation of assets.

Appellant's customers are located throughout various parts of the United States, Canada, and Europe (R. 98). It purchases its hides in Chicago and other western packing centers, and pays for them on sight drafts, the hides being shipped by the packers direct to the tannery at Asheville (R. 98). A portion of its tanning materials is purchased in North Carolina; and the other materials are purchased in the New York market, chiefly quebracho and cod oil. These materials are also shipped to the tannery (R. 99). The only sales office is located at New York City (R. 100). The traveling salesmen representing the Company travel throughout the country and report to the New York office. When an order is received for a sale, it is filled from New York stock if they have it in hand there; and if not, a requisition is sent by New York to the tannery at Asheville to fill the order (R. 101). An attempt is always made to keep stock to meet the requirements of the customers in the New York ware-

house (R. 110). All of the invoices for sales are made out in New York, and all payments are made to New York (R. 103). The North Carolina business is essentially manufacturing. With average sales of approximately $2,500,000, less than an average of $7,000 was sold to customers in the State of North Carolina (R. 134).

In each year appellant paid property taxes on the property owned in North Carolina, and also franchise taxes for the privilege of doing business in North Carolina. The amounts of these taxes were as follows (R. 138):

Year	Property Taxes	Franchise Taxes
1923	$18,276.52	$ 772.70
1924	16,152.97	723.20
1925	19,652.84	1,052.69
1926	22,170.00	1,052.69

The North Carolina corporation income tax is not a commutation tax or levied in lieu of property or franchise taxes. The State's position on this point was stated in the brief of the Attorney General in the State Supreme Court, as follows:

> "The income tax in North Carolina is in no sense a tax for the privilege of doing business in the state, nor does the statute anywhere deprive one of the privilege of doing business from failure to pay the tax. This indeed as the statute shows it to be, is a tax upon the net income earned in the state."

While the major part of the manufacturing is carried on at Asheville, a substantial part is also done in New York (R. 103). Much of the finishing of the leather and the cutting it up to meet special requirements is done at the New York factory.

Appellant's business is divided into two parts,—wholesale and retail (R. 108, 109). On the wholesale side, ship-

ments are made in carload lots in direct competition with other tanners and at established wholesale prices for leather. Generally speaking, the wholesale business is shipped direct from the tannery to the customers on orders sent by the New York office (R. 101, 102, 104, 107).

In the retail part of the business, the leather is cut up into small pieces, and finished in particular ways, and supplied in small lots to meet the particular needs of individual customers. Few, if any, of the other tanners engage in this retail business. Essentially, this part of the business is a retail merchandising business, conducted from the New York office, and factory, and by the New York office (R. 101, 102, 106, 108).

The operations which together result in the Company's total net income can be divided into three major groups, —buying, manufacturing, selling. Practically all of the buying and substantially all of the selling takes place outside of North Carolina (R. pp. 98-103, 110, 113, 115, 134). Most of the manufacturing, but not all, takes place in the State of North Carolina (R. pp. 97, 103, 110).

Appellant's evidence consisted of an analysis of its accounts for the four years in question to determine the gross profit from these major divisions—buying, manufacturing, and selling, and an allocation of these profits between the retail and wholesale departments.

In the analysis of the source of appellant's income, the apportionment was, of course, of gross profits before the deduction of certain general overhead expenses required to reach net income. The gross income considered in the analysis is, therefore, greater than the net income to which the resulting apportionment percentage is applied as is shown in the following table:

Year	Total Net Income	Gross Profits
1923	$231,927.90	$ 400,413.80
1924	257,881.70	403,286.67
1925	146,561.43	322,274.87
1926	106,727.55	169,250.90
Total	$743,098.58	$1,295,226.24

(R. 15, 16, 32, 127, 128.)

These gross profits were strictly operating profits and did not include the income from investments elsewhere discussed which was however included in the total net income.

In separating the gross profits into its three sources—buying, manufacturing, and selling,—the existing classification between wholesale and retail business afforded an obvious and convenient starting point. The profits from the retail business which was exclusively conducted from New York obviously were much less attributable to North Carolina than was the case with the wholesale business. The profits from the wholesale business were in part attributable to the manufacturing in Asheville and in part to the selling in New York. But the Company's accountants made no attempt to separate this. The entire wholesale profit was credited to manufacturing and allocated to North Carolina. Similarly, no attempt was made to allocate profits from manufacturing in New York from profits from manufacturing in Asheville. All manufacturing profits were allocated to North Carolina.

The analysis of appellant's accounts, therefore, sought to segregate (1) the selling profit on retail sales, (2) the buying profit, and (3) the manufacturing profit.

Retail Merchandising or Selling Profit.

The different parts of a hide make leather of different quality; and they sell for different prices,—that is, the heads and bellies are inferior in quality and sell for a lower price than the centers and sides (R. 104, 111). There are published wholesale market quotations for these different assortments of leather. These quotations represent the daily prices received by tanners throughout the country for their leathers (R. 120). A comparison of these public market prices with the prices actually received by appellant showed that as to the leather which it sold at wholesale in competition with other tanners, it received rather less than the average market price; while as to the leather which it specially finished and sold at retail, it received considerably more than the market price. It is contended that this difference or surplus price after deducting the extra cost of this retail business is strictly a selling or merchandising profit, which is not attributable to operations in North Carolina. Making this statistical analysis, the following results are shown (R. 120, 121):

HEADS.

Year	Market Price	Price Appellant Received
1923	13¢	10.34¢
1924	12.5¢	9.6¢
1925	15¢	12.19¢
1926	16¢	14.61¢

BELLIES.

1923	24¢	19.95¢
1924	20.75¢	19.17¢
1925	24.5¢	23.02¢
1926	27¢	26.48¢

Heads and bellies are sold by appellant in carload lots at wholesale, and in competition with other tanners; and the above comparison of prices indicates that appellant does not receive a premium over market price based upon any special manufacturing conditions or quality. In contrast with these wholesale prices, the rest of the hide, which is commonly called the butt, is cut up by the appellant and sold at retail. In comparing the price received by appellant for its retail sales with the average market price for the same class of leather, the additional cost to the appellant of cutting up and finishing this leather was deducted from the price received, so that the two prices could be fairly comparable. After making that calculation, the following results appear (R. 122-124):

BUTTS.

Year	Market Price	Appellant's Price
1923	67.521¢	73.612¢
1924	55.25¢	64.007¢
1925	57.666¢	62.996¢
1926	55.866¢	61.891¢

The fact that on its wholesale business the appellant received a uniformly lower price for its product than the prevailing published market price justifies the conclusion that since it received a higher price than the market price on its retail sales, this was attributable entirely to its merchandising activities outside of North Carolina, and not to any special quality or other factor affecting the price of its leather. If the net excess of price received on its retail sales is multiplied by the number of pounds sold in each year, an approximate estimate of the merchandising profit in those years can be obtained. This merchandising profit so calculated for the four years was as follows:

1923	$184,796.70 (R. 127)
1924	252,970.90 (R. 126)
1925	167,065.92 (R. 125)
1926	195,204.22 (R. 124)

The selling profits as thus calculated are not the total gross profits of this retail business. In three of the four years the gross retail profits materially exceeded the calculated selling profits, and left a substantial sum to be crediting to buying and manufacturing (R. 128-129).

Year	Gross Profits, Retail Business	Allocated as Selling Profit	Balance to Buying and Manufacturing Profit
1923	$330,699.95	$184,796.70	$145,903.25
1924	304,578.55	252,970.90	51,607.65
1925	251,952.70	167,065.92	84,886.78
1926	133,468.60	195,204.22	Loss 61,735.62

Buying Profit.

Since the price of hides is such a large part of the total cost of the leather, and since that price fluctuates widely, the profit in the tanning business is materially affected by the skill with which hides are bought through the year. As is the case with leather, hides are sold on a published daily market (R. 130); and as the price of leather is in the long run governed by the average cost of hides, a comparison of the actual cost of appellant's hides with the average cost of hides of similar quality sold in the market during the year gives an approximate indication of the profit or loss fairly to be attributable to the company's hide buying operations, which are not at all conducted in North Carolina. These comparisons show the following results (R. 130-134):

Year	Market Price of Steer Hides	Appellant's Cost of Steer Hides	Market Price of Cow Hides	Appellant's Cost of Cow Hides
1923	16.75¢	14.80¢	13¢	15.64¢
1924	14.5¢	13.14¢	12¢	9.87¢
1925	16¢	15.44¢	14.75¢	14.35¢
1926	14¢	13.42¢	13¢	12.58¢

Multiplying these differences by the number of pounds purchased in the respective years shows total buying profits as follows:

1923	$57,264.22
1924	93,026.42
1925	31,928.49
1926	31,521.01

The gross profit of 1923 was arrived at by deducting a loss of $37,006.09, excess cost of cow hides, from a saving of $94,270.31 profit on the purchase of steer hides.

Manufacturing Profit.

If the buying and merchandising profits as thus calculated are substracted from the gross profits for the year, the remainder represents what we have called the manufacturing profit. While a portion of this manufacturing is done at the factory in New York, no attempt is made in the calculations to separate this item. This so-called manufacturing profit also includes the selling profit on the wholesale business. Nevertheless the entire so-called manufacturing profit as thus obtained is credited to operations in North Carolina. Making this calculation, the following results appear:

1923:

Gross profit retail sales (p. 129)		$330,699.95
Gross profit wholesale sales (p. 129)		69,713.85
A. Total gross profit		$400,413.80
Buying profit (*supra*)	$ 57,264.22	
Selling profit (*supra*)	184,796.70	
B. Total	$242,060.92	$242,060.92
Manufacturing profit (difference A and B)		$158,352.88

1924:

Gross profit retail sales (p. 128)		$304,578.55
Gross profit wholesale sales (p. 128)		98,708.12
A. Total gross profit		$403,286.67
Buying profit (*supra*)	$ 93,026.42	
Selling profit (*supra*)	252,970.90	
B. Total	$345,997.32	$345,997.32
Manufacturing profit (difference A and B)		$ 57,289.35

1925:

Gross profit retail sales (p. 128)		$251,952.70
Gross profit wholesale sales (p. 128)		70,322.17
A. Total gross profit		$322,274.87
Buying profit (*supra*)	$ 31,928.49	
Selling profit (*supra*)	167,065.92	
B. Total	$198,994.41	$198,994.41
Manufacturing profit (difference A and B)		$123,280.46

1926:

Gross profit retail sales (p. 127)		$133,468.60
Gross profit wholesale sales (p. 127)		35,782.30
A. Total gross profit		$169,250.90
Buying profit (*supra*)	$ 31,521.01	
Selling profit (*supra*)	195,204.22	
B. Total	$226,725.23	$226,725.23
Manufacturing loss (difference A and B)		$ 57,474.33

For the four years the totals and averages of this analysis, then are:

Total gross profits of	$1,295,226.21
Total buying profits of	$213,740.14 or 16.5%
Total selling profits of	800,037.74 or 61.8%
Total manufacturing profits of	281,448.36 or 21.7%

We have shown that net income was only about 60% of gross profits. For the four years North Carolina has allocated and taxed total net income of $604,121.86 while total gross profits earned in the State only amounted to $281,448.36, or less than half the amount of net income subjected to tax.

Since the evidence was undisputed that the buying of hides and the retail selling of the leather were neither in any respect North Carolina operations, this allocation of business and income indicates that the percentage of income attributable to North Carolina in no event exceeds 21.7%. If the manufacturing profit were further analyzed to separate the profit from New York manufacture and the part of wholesale profits attributable to selling effort outside the State the percentage of income fairly attributable to operations in North Carolina would be further reduced.

The accountant who testified carried the analysis of the sources of profits further than the above computation. The method of the calculation does not appear in detail in the condensed statement of the testimony. In general, it represented an attempt to compute the manufacturing profit independently and not as a remainder of gross profit after deducting the sums definitely allocated as buying and retail selling profits. It was based on a comparison of the actual cost of appellant's leather with what it could have purchased the same leather for in the open market.

On this direct computation the manufacturing profit was:

For 1923	$145,903.25 or 37%	(p. 137)
" 1924	51,607.65 or 13%	(p. 136)
" 1925	84,866.88 or 26%	(p. 136)
" 1926 (Loss) ...	61,735.62	(R. 135)

An average of 17% of gross profits derived from tanning and manufacturing operations. This is the allocation assumed to be established by the evidence by the Supreme Court of North Carolina in its opinion upholding the constitutional validity of the tax (R. 164).

So far as the issue of this appeal is concerned, it seems unnecessary to determine whether the average percentage of income earned in the State is 17% or 21.7%. Under the statute the appellant has been taxed on an allocated percentage of 80% of income. If the tax is illegal on an actual apportionment of 17%, it is equally illegal on an actual apportionment of 21.7%.

The substantial accuracy of appellant's apportionment of income and the claim that only a relatively small part thereof can be fairly attributed to the manufacturing operations in the State, is confirmed by other evidence.

In 1919 the appellant purchased 355,488 pounds of leather in the open market, which it cut up and sold at retail. It also tanned a considerable quantity of similar leather, which it sold in the same way. It made a profit of 22.26¢ a pound on the leather which it purchased, and only 13.57¢ a pound profit on the leather sold of its own tannage. In that year the evidence is thus clear that its entire profit was in the retail selling of the leather, and that its manufacturing operations resulted in an actual loss. While the tax for this year is not in controversy, the actual facts of that year are pertinent as to the accounting accuracy of appellant's apportionment theory in the years here in question (p. 119).

At certain times in this industry there is a custom of "tanning contracts." Under such contracts a tanner, who for any reason is not in a position to tan and merchandise his own leather, agrees to tan hides for others at a fixed price per pound. In a given year these tanning contracts are substantially uniform in price. In three of the years here in question appellant could have had its leather tanned for it by others under these tanning contracts. A comparison of these tanning contract prices with what it actually cost appellant to tan its own leather shows that in two years it cost it more to tan its own leather than it would have cost under a tanning contract; while in one year its actual cost was less than it would have been under a tanning contract (pp. 107, 108, 114, 129, 130). The actual figures are:

Year	Pounds of Leather Tanned	Contract Cost Per Pound	Appellant's Actual Cost Per Pound	Difference Manufacturing Cost
1923	5,091,311	14½¢	13.95¢	$28,002.21
1925	4,796,036	12¢	13.67¢	80,093.80
1926	5,299,637	12¢	13.84¢	97,513.32

These figures indicate that the manufacturing profit should have been relatively large in 1923, and small in 1925 and 1926. The computed manufacturing profit in those years (*supra*) was:

In 1923	$145,903.25
" 1925	84,866.88
" 1926 (Loss)	61,735.62

The computed figures therefore conform generally to the results that the "tanning contract" comparisons would indicate.

Most of the other tanners in the country do exclusively a wholesale business. A comparison of the net profits on investment and on total sales realized by appellant with that of other large tanners who do not engage in retail selling shows that the appellant's rate of profit was much higher than that of other tanners. This again corroborates its computation that allocates the main profits of the business to its special selling effort. These comparative figures are:

In 1923 and 1924 the Central Leather Company, with assets of $107,271,766.56, had a net loss, and in 1925 a profit of 2¾% on its investment, and in 1926 a profit of 1.6% on its investment. For the four-year period it earned a little less than nothing on its investment (p. 114).

In 1924 the National Leather Company, with assets of $28,365,474.67, had a profit return on investment of 3.4%; in 1925 a return of 2.8%; and in 1926 a net loss. The average return on investment for the three years was less than 2% (p. 114).

On the other hand, in 1923 appellant had a net return on its investment of 14.2%; in 1924 of 10.8%; in 1925 of 5.75%; and in 1926 of 4.37%; an average return for the four years of 9% on investment (pp. 134, 135).

The National Leather Company reported a profit on sales of 2.75% in 1925, and of 3.6% in 1924. These are the only available sales reports of other companies (p. 114). The appellant had a profit on sales in 1925 of 6% and in 1924 of 12% (pp. 134, 135).

A final check on appellant's allocation of profits is the ratio of profits to sales on the retail as compared to the wholesale end of the business. The retail sales show a much higher rate of profit, and this fact is further confirmation of the substance fact that the profits of the business are mostly earned outside of North Carolina. The comparative figures on this check are as follows:

Year	Per Cent. of Profit, Retail Sales	Per Cent. of Profit, Wholesale Sales
1923	17.39	10.91
1924	19.66	17.14
1925	15.29	9.97
1926	8.00	5.32
Average	15.09	10.82

(pp. 127-129)

The retail sales have a rate of profit about fifty per cent. higher than the wholesale sales.

We submit that the appellant's evidence that the Court below struck out as immaterial was clearly sufficient to establish that in actual fact the income derived from its operations in North Carolina was vastly less than that upon which it has been taxed under the statutory allocation here drawn in question.

POINT II.

The order striking out all of appellant's evidence as immaterial was reversible error.

At the conclusion of the trial in the Superior Court, that Court granted the State's motion to strike from the record all of appellant's testimony as immaterial; and the appellant duly excepted and urged that ruling as error on the appeal to the State Supreme Court. This error is also urged in the Assignments of Error in this Court. The appellant's evidence which was thus excluded has been summarized and analyzed in the preceding point.

Any objection as to the form of the evidence or as to the competency of the testimony of the various witnesses who testified to the facts introduced in evidence was expressly waived. The parties stipulated that the original books of the appellant need not be introduced in evidence as a foundation for the testimony of the witnesses based on said books, and that the State would not object to any testimony because those books were not introduced in evidence (R. pp. 95, 96). The sole objection to this evidence on the part of the State was that it was immaterial. The Court's action in striking out all of this evidence was expressly based upon the ground that the entire evidence was immaterial (R. pp. 151, 93).

This ruling was clearly erroneous, and the evidence was material. This was true for two reasons,—first, because the appellant cannot be heard to attack the constitutionality of the statute unless he shows that he is hurt by the alleged invalidity; and second, because the facts as to the application of the statute to the appellant are material

evidence on the fundamental question as to whether the statute is arbitrary or reasonable. While it may be that a court could say that a tax classification based upon the color of a man's hair was obviously inherently arbitrary, ordinarily the question of whether or not a statute is arbitrary and unconstitutional can only be determined by observing its application in particular cases. Therefore, appellant's evidence was material, not only for the purpose of showing that it was hurt and therefore in a position to attack the statute, but also as affording a certain measure of fact and of evidence by which the reasonableness of the statute could be tested. This rule is so well established in this Court, that it is unnecessary to cite many cases.

In *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, the plaintiff attacked a Connecticut statute which was in many respects similar to the one here under consideration. The evidence offered by the Underwood Company did not attempt to show the actual sources of its income, and that company relied upon the contention that the statutory method of allocation was inherently arbitrary and therefore invalid. Under the statutory allocation, 47% of the Underwood Company's income was apportioned to Connecticut. In deciding against the Underwood Company's attack on the law, this Court said at page 121:

> "* * * for aught that appears the percentage of net profits earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result.

> "We have no occasion to consider whether the rule prescribed if applied under different conditions might be obnoxious to the Constitution."

In *American Mfg. Co.* v. *St. Louis*, 250 U. S. 459, the Court said at page 462:

> "But as has been held very often, the question of whether a state law or a tax imposed thereunder deprives a party of rights secured by the Federal Constitution depends not upon the form of the act, nor upon how it is construed or characterized by the state court, but upon its practical operation and effect."

In *Shaffer* v. *Carter*, 252 U. S. 37, the Court said at page 55:

> "For, where the question is whether a state taxing law contravenes rights secured by that instrument, the decision must depend not upon any mere question of form, construction, or definition, but upon the practical operation and effect of the tax imposed."

In *Dahnke-Walker Co.* v. *Bondurant*, 257 U. S. 282, the Court said:

> "A statute may be invalid as applied to one state of facts and yet valid as applied to another. Poindexter *v.* Greenhow, 114 U. S. 270, 295; St. Louis, Iron Mountain & Southern Ry. Co. *v.* Wynne, 224 U. S. 354; Kansas City Southern Ry. Co. *v.* Anderson, 233 U. S. 325. Besides, a litigant can be heard to question a statute's validity only when and so far as it is being or is about to be applied to his disadvantage. Yazoo & Mississippi Valley R. R. Co. *v.* Jackson Vinegar Co., 226 U. S. 217; Jeffrey Manufacturing Co. *v.* Blagg, 235 U. S. 571, 576."

While the order striking out all of appellant's evidence showing the practical application of the statute in question to it as immaterial was thus evidently error, appellant recognizes that such error is not ground for reversal unless it appears that it affected the result of the case.

> *Judicial Code*, Section 269; 28 U. S. C. A. 391; *Liberty Oil Co.* v. *Condon Bank*, 260 U. S. 235; *Camp* v. *Gress*, 250 U. S. 308.

Upon the appeal in the State Supreme Court, that Court in affirming the judgment held that the ruling of the trial court striking out appellant's evidence was not error, apparently upon the ground that considering the evidence as in the record, it would not change the result. After briefly reviewing the general character of appellant's evidence, the opinion of the State Supreme Court continued as follows:

> "Without burdening this opinion with detailed compilation set out in the record, the evidence offered by the petitioner tends to show that for the years 1923, 1924, 1925, and 1926, the average income having its source in the manufacturing and tanning operations within the State of North Carolina was seventeen per cent. Upon such evidence the petitioner earnestly contends that the taxing statute of North Carolina in its operation and application is unreasonable and arbitrary and hence repugnant to the Federal Constitution" (R. p. 164).

The State Supreme Court based its decision that the order striking out appellant's evidence was correct upon an interpretation of the unit rule, or the unitary business rule, and relied upon

Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113;
Bass, Ratcliff & Gretton v. *State Tax Com.*, 266 U. S. 271;
Adams Express Co. v. *Ohio*, 165 U. S. 194.

The State Court apparently construed these cases as establishing that since in a unitary business a statutory rule of apportionment or valuation of one kind of property upon the basis of an assumed relationship to another kind of property may be valid, *in the absence of evidence that the statutory rule works injustice*, therefore evidence showing that in such business the statute works injustice in fact is inadmissible. In so doing, we submit that the State Supreme Court clearly erred and misinterpreted the decisions of this Court upon which it relied.

We have found twenty-three cases in this Court involving the constitutionality of a state statute in which an apportionment on the unitary business theory was used. These cases have considered different subjects of taxation and different rules of apportionment. But they all had one common factor. They imposed a tax upon a proportion of the corporation's total property or income or stock, that proportion being determined by the relation that some other and particular kind of property in the State bore to the total property of that kind wherever situated.

In none of these cases has it been held or suggested that evidence showing that the practical application of the statutory formula worked an injustice was immaterial. The State Court's conclusion that these cases support its decision that appellant's evidence was immaterial is wholly unfounded. On the contrary, in every case in

which the question has arisen, this Court has expressly recognized the materiality of this kind of evidence.

In six cases the Court has held a state apportionment statute unconstitutional on evidence showing that the statutory formula worked an unjust result on the particular facts of the complaining taxpayer.

In *Fargo* v. *Hart*, 193 U. S. 490, a tax was levied upon that proportion of the total property of the Express Company that the mileage operated in Indiana bore to the total mileage. The taxpayer introduced evidence showing that this statutory rule of apportionment based upon mileage was, as applied to it, unfair and resulted in a tax upon a greater amount of property than was in fact in the State or subject to the State's taxing jurisdiction. In holding that under the facts of the case the apportionment statute imposed an unconstitutional burden, this Court said:

> "And when that property is part of a system and has its actual uses only in connection with other parts of the system, that fact may be considered by the State in taxing, even though the other parts of the system are outside of the state * * *. This being clear, it is held reasonable and constitutional to get at the worth of such a line in the absence of anything more special, by a mileage proportion. The tax is a tax on property, not on the privilege of doing the business, but it is intended to reach the intangible value due to what we have called the organic relation of the property in the State to the whole system * * *.
>
> "It is obvious, however, that this notion of organic unity may be made a means of unlawfully taxing the privilege, or property outside the State, under the name of enhanced value or good will, if it is not closely confined to its true meaning."

In *Oklahoma* v. *Wells Fargo*, 223 U. S. 298, the tax was on that proportion of the total gross receipts of the company that the business done within the State bore to the whole of its business. A complaining taxpayer introduced evidence showing that its gross revenues included income from bonds and other property situated without the State; and on such evidence this Court held the statute unconstitutional as applied to this taxpayer on the authority of *Fargo* v. *Hart* (*supra*), as to which the Court said:

> "In that case the tax was proportioned to mileage and it was held that it could not be sustained, when, although purporting to be a tax on property, it took into account, in order to increase proportionately the value of the mileage within the State, valuable property outside of it. The same principle would apply to a property tax measuring the total property by the total gross receipts increased by the special outside sources of income and taxing a proportion of this total fixed by the ratio of business within the State to that outside."

In *Illinois Central Rd.* v. *Greene*, 244 U. S. 555, the tax was on an allocated proportion of the total capital stock. The statutory allocation was based upon the mileage in the State as compared to the total mileage. The taxpayer introduced evidence showing that upon the particular facts of this case the statutory allocation produced an unfair result; and on this evidence this Court held the statute invalid, the Court saying:

> "* * * a state cannot tax property outside of its jurisdiction belonging to persons domiciled elsewhere, and that although the fact that property is part of a system and has its actual uses only in connection with other parts of the system may be con-

sidered by the State in taxing that portion of the system which is within its borders, yet the notion of organic unity must not be made the means of unlawfully taxing property without the State."

In *Union Tank Line* v. *Wright*, 249 U. S. 275, the tax was on the value of the average number of cars in the State during the year. This value was reached by a statutory formula of allocation based on the proportion that the mileage in Georgia bore to the total mileage. The taxpayer showed that the application of this rule resulted in a valuation of its cars within the State of Georgia greatly in excess of their actual value. In holding the statutory rule of apportionment invalid upon this evidence, the Court said:

"A state may not tax property belonging to a foreign corporation which has never come within its borders—to do so under any formula would violate the due process clause of the 14th Amendment. In so far, however, as moveables are regularly and habitually used and employed therein, they may be taxed by the state according to their fair value * * *. While the valuation must be just it need not be limited to mere worth of the articles considered separately, but may include as well 'the tangible value due to what we have called the organic relation of the property in the state to the whole system.' How to appraise them fairly when the tangibles constitute part of a going concern operating in many states often presents grave difficulties; and absolute accuracy is generally impossible. We have accordingly sustained methods of appraisement producing results approximately correct—for example, the mileage basis in case of a telegraph company, and the average amount of property habitually brought in and carried out by a car company. But if the plan pursued is arbitrary

and the consequent valuation grossly excessive, it must be condemned because of conflict with the Commerce Clause or the Fourteenth Amendment or both * * *.

"We think the plaintiff-in-error's property was appraised according to an arbitrary method which produced results wholly unreasonable and that to permit enforcement of the proposed tax would deprive it of property without due process of law and also unduly burden interstate commerce * * *.

"In other opinions of this Court cited below to support the conclusion there reached we upheld the power of a state to tax property actually within its jurisdiction upon a fair valuation considered as part of a going concern—they give no sanction to arbitrary and inflated valuations. Taxes must follow realities; not mere deductions from inadequate or irrelevant data."

In *Wallace* v. *Hines*, 253 U. S. 66, there was involved an excise tax for the privilege of doing business in the State. The base was the total value of property apportioned in accordance with main line mileage in the State and elsewhere. In holding the statute bad upon evidence showing that the property outside was relatively more valuable than that in the State, the Court said:

"The only reason for allowing a state to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart—not, in other words, to open to taxation what is not within the state. Therefore no property of such an interstate road situated elsewhere can be taken into account unless it can be

> seen in some plain and fairly intelligible way that it adds to the value of the road and the rights exercised in the state. Hence the possession of bonds secured by mortgage of lands in other states, or of a land grant in another state or of other property that adds to the riches of the corporation but does not affect the North Dakota part of the road is no sufficient ground for the increase of the tax—whatever it may be—whether a tax on property, or, as here, an excise upon doing business in the State."

In *Southern Ry.* v. *Kentucky*, 274 U. S. 76, a franchise tax based upon the capitalization of net operating income was before the Court. Allocation of income was on the basis of mileage within and without the State, less the assessed value of tangible property. The Court discussed the application of the unit rule as made by it in other cases, and said:

> "The mileage used as an integral part of a railroad system may have elements of value that it otherwise would not possess, and the state properly may have regard to the whole in order to ascertain the value of the part that is within its borders. Fargo *v.* Hart, *supra*, 499. But if the method pursued in valuing property within the state is arbitrary and the resulting valuation is grossly excessive the tax must be condemned as in contravention of the due process clause of the 14th Amendment. Union Tank Line Co. *v.* Wright, *supra*, 282 and cases cited. It is not permissible for the state to take into account any of the outside property 'unless it can be seen in some plain and fairly intelligible way that it adds to the value of the road and the rights exercised in the state.' Wallace *v.* Hines, *supra*, 69."

After discussing the evidence showing the practical application of the statute and the rule of apportionment

to the facts in the case, the Court held the statute unconstitutional, saying:

> "The mere statement of the figures is sufficient to show that the amount added as a basis for franchise taxes is so excessive and unreasonable that it cannot be sustained."

The figures in this case upon which the Court based its decision showed that while the railroad as a whole produced satisfactory net profits, the lines in Kentucky were operated at a loss; and on this showing of fact the Court held the application of the unit rule was arbitrary and void. While this decision was not by a unanimous court, the dissenting opinion was expressly based, not on the merits, but on a failure to raise the objections properly in the Court below.

In five cases the Court has sustained a state apportionment statute on the express ground that the taxpayer had failed to prove that as applied to it the statutory formula worked unjustly.

In *Adams Express Co.* v. *Ohio*, 165 U. S. 194, and *Adams Express Co.* v. *Indiana*, 165 U. S. 255, state statutes imposing property taxes allocated in proportion to the length of lines over which the business was done within and without the State were upheld in cases which were elaborately argued and were decided by a divided court. In applying the unit of use rule, the Court said:

> "As to railroad, telegraph and sleeping car companies, engaged in interstate commerce, it has often been held by this court that their property, in the several States through which their lines or business extended, might be valued as a unit for the purposes of taxation, taking into consideration the uses to which it was put and all the elements making up

aggregate value, and that a proportion of the whole fairly and properly ascertained might be taxed by the particular State without violating any Federal restriction. * * *

"Doubtless there is a distinction between the property of railroad and telegraph companies and that of express companies. The physical unity existing in the former is lacking in the latter; but there is the same unity in the use of the entire property for the specific purpose, and there are the same elements of value arising from such use. * * *

"We repeat that while the unity which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience or pecuniary profit of the owner, but existing in the very necessities of the case—resulting from the very nature of the business."

But in approving the application of the statutory rule of apportionment in that case, the Court recognized that it was not an inflexible rule, but one to be applied only when appropriate under the facts shown in the particular case. Thus the Court said at page 227:

"Special circumstances might exist, as indicated in Pittsburgh, Cincinnati &c. Railway *v.* Backus, 154 U. S. 421, 443, which would require the value of a portion of the property of an express company to be deducted from the value of its plant as expressed by the sum total of its stock and bonds before any valuation by mileage could be properly arrived at, but the difficulty in the cases at bar is that there is no showing of any such separate and distinct property which should be deducted, and its existence is not to be assumed. It is for the companies to present any special circumstances which may exist, and, failing their doing so, the presumption

> is that all their property is directly devoted to their business, which being so, a fair distribution of its aggregate value would be upon the mileage basis."

In his dissenting opinion in this case, Mr. Justice WHITE clearly foreshadowed the subsequent decision of the Court upon one of the statutes there involved. At page 251 he said:

> "This court has effectually determined that where a corporation is engaged in interstate business, no one of the States has the power to tax the receipts of such company derived from interstate commerce business, and that the power of the States as to taxation on earnings is limited to those derived from the business done within the State. This line of concluded authority is illustrated and referred to in the recent opinion in Osborne *v.* Florida, 164 U. S. 650, decided at this term. It is, therefore manifest that where property owned in common, belonging to the same person and situated in different states, contributes to earnings, and the proceeds of these earnings go into the treasury of the owner, and lie side by side therein, that the fact that there is a common owner, that there is a common business, and that all the results of the business are in immediate contact in the common treasury, gives no power to the State to tax the whole, but only to levy on that which comes from the state business alone."

When in *Fargo* v. *Hart, supra,* the taxpayer introduced evidence showing that in fact under the same statute its practical application to it worked an injustice, the Court held the statute invalid. These two cases alone are sufficient to establish the materiality of appellant's evidence in this case at bar.

In *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113 (*supra*), the Court sustained a Connecticut tax upon the income of a foreign corporation apportioned, as here, upon the basis of tangible property within and without the State. In that case the taxpayer offered no evidence to show that the statutory rule of apportionment in fact operated unjustly upon it. The decision of the Court upholding the tax was expressly based upon the taxpayer's failure to show that the percentage of net profits actually earned in Connecticut was less than that allocated under the statutory formula. We have quoted from the opinion of this Court to this effect, *supra*, page 34.

In *Bass, Ratcliff & Gretton* v. *State Tax Com.*, 266 U. S. 271, the New York income tax upon a foreign corporation was involved. The tax was based upon an apportioned part of the total net income of the corporation. The statutory formula of apportionment took into account both tangible and intangible property within and without the State. The tax was sustained upon several grounds, one of which was that there was no evidence in the record that the income allocated to New York exceeded the net income actually earned from the business in that State. Not only was there no ruling in that case that evidence showing that the application of the statute was unjust or unreasonable would be immaterial, but the decision was expressly rested in part upon the ground that the company had failed to introduce such evidence.

In *Great Northern Railway* v. *Minnesota*, 278 U. S. 503, the tax was upon the gross earnings in lieu of all property taxes. The gross earnings were those from business wholly within the State, plus an allocated part of gross earnings from the interstate business, in the proportion of the mileage in the State to the total mileage. This case, therefore, involved a State tax on the local prop-

erty of a railroad company, in which the unit rule was invoked. The company attacked the assessment as violative of the Commerce Clause and of the Fourteenth Amendment upon the ground that the gross receipts included rents from docks located in Wisconsin. The Court sustained the tax upon the ground that the evidence did not show the actual use value of either part of the road or their relative values, and that if all the facts were shown, it was equally probable that the Minnesota tax would be too low as it was that it would be too high. The application of the unit rule was sustained upon the express ground that the record did not show affirmatively that it was unfair.

In *Pullman Co.* v. *Richardson*, 261 U. S. 330, the tax was measured by the gross receipts within the State, and these receipts in turn were based in part upon a mileage proportion within and without the State. There was no attempt made to show that the result was in fact unfair. The tax was imposed in lieu of all other taxes and was sustained as a reasonable property tax. It is not wholly clear whether the apportionment was sustained because of the failure of the taxpayer to introduce evidence showing that it worked an injustice, or whether this case falls in the next group of cases in which the fairness of the apportionment was not involved, and the attack on the statute was based upon other grounds.

In the remaining twelve cases, the justice or constitutionality of the apportionment formula was not involved or considered. In them, the question was whether the tax could be levied at all. These cases were

Western Union Telegraph Co. v. *Mass.*, 125 U. S. 530;

Pullman Palace Car Co. v. *Penna.*, 141 U. S. 18;
Pittsburgh Rd. v. *Backus*, 154 U. S. 421;
Henderson Bridge Co. v. *Kentucky*, 166 U. S. 150;
Amer. Refrigerator Transit Co. v. *Hall*, 174 U. S. 70;
Union Refrigerator Co. v. *Lynch*, 177 U. S. 149;
U. S. Express Co. v. *Minnesota*, 223 U. S. 335;
Louisville & Nashville Rd. v. *Greene*, 244 U. S. 522;
Cudahy Packing Co. v. *Minnesota*, 246 U. S. 450;
Hump Hairpin Mfg. Co. v. *Emmerson*, 258 U. S. 290;
National Leather Co. v. *Mass.*, 277 U. S. 413;
Western Cartridge Co. v. *Emmerson*, 281 U. S. 511.

In a few of these cases the opinion of the Court referred to the statutory formula based upon the unitary business theory as a fair method of apportionment; but where that was true, subsequent decisions of the Court showed that in these cases such a statement was obiter dictum, and that the question of the constitutionality of the apportionment formula was not in issue.

Thus, in *Western Union Co.* v. *Mass.*, 125 U. S. 530, the Court refers to the statutory apportionment on mileage as just and fair; but in Judge BRADLEY'S dissenting opinion in *Pullman Palace Car Co.* v. *Pennsylvania*, 141 U. S. 18, he said, with reference to the *Western Union* case, that some of the judges felt a doubt whether the statutory rule of value was valid, and he continued:

> "But the difficulty of getting at the true value of the property within the state and of adopting any other rule for ascertaining it, as well as the failure

of the company to show that the rule adopted produced any unfair results, finally induced an acquiescence in the decision."

Pullman Palace Car v. *Penn.*, 141 U. S. 18, is often cited as approving the statutory apportionment on the mileage basis. The fairness of that rule was not discussed in the opinion in that case; but in so far as the decision was in fact based upon an approval of the statutory formula, it was expressly overruled in *Union Tank Line* v. *Wright*, 249 U. S. 275.

We submit that these cases establish that the State Court erred in its interpretation of the unit rule, and that there is no authority holding that in a unitary business, evidence as to the practical application of a statutory rule of apportionment is inadmissible or immaterial.

But the State Court's conclusion on this point rested not only on an error of law, but also on an error of fact. It treated appellant's business as a unitary business within the meaning of that term as used in the foregoing decisions. In fact, the evidence shows appellant's business is not unitary, but consists of two distinct parts. The profits from the retail selling business conducted in New York have no direct or necessary connection with the manufacturing business conducted in North Carolina. In this respect this case is brought squarely within the terms of the exception made by the Court in

Adams Express Co. v. *Ohio*, 165 U. S. 194,

where the Court said:

> "The same party may own a manufacturing establishment in one State and a store in another, and may make profit by operating the two, but the work of each is separate. The value of the factory

> in itself is not conditioned on that of the store or *vice versa*, nor is the value of the goods manufactured and sold affected thereby. The connection between the two is merely accidental and growing out of the unity of ownership."

Applying this rule, we can correctly say that the profits of the New York retail business are not conditioned on the value of the Asheville factory.

Looking, then, at substance and not at form, at realities and not at legal fiction, the question whether or not the order striking out all of appellant's evidence was reversible error depends upon two questions:

> 1st.—Did appellant's evidence show that in fact the taxes assessed against it were unjust, and that an unreasonable part of its income was apportioned as having its source in North Carolina?

We have discussed this evidence in detail in the preceding point, and have shown that the answer to this question must be in the affirmative.

> 2nd.—Is a state statute construed to impose a tax upon eighty per cent. (80%) of the income of a foreign corporation, while in fact only seventeen per cent. (17%) of the income had its source within the State, an unconstitutional statute?

In the following points we show why we submit that the answer to this question must also be in the affirmative.

If the answer to these two questions is in the affirmative, then we submit that the judgment of the State Court should be reversed upon the ground of error in striking out appellant's evidence.

POINT III.

The North Carolina Revenue Acts of 1923 and 1925 as construed and applied to appellant are invalid and unconstitutional because repugnant to the Fourteenth Amendment to the Federal Constitution as depriving appellant of its property without due process of law.

That taxation by a state of persons or property outside its jurisdiction and within the jurisdiction of another state constitutes a taking of property without due process of law is "firmly established" (216 U. S. 1); "has been repeatedly held by this Court" (199 U. S. 194); "No principle is better established" (153 U. S. 628).

Cleveland, etc., Company v. *Pa.* (State Tax on Foreign Held Bonds), 15 Wall. 300;
New York, Lake Erie & Western v. *Pa.*, 153 U. S. 628;
Union Refrigerator Transit Co. v. *Kentucky*, 199 U. S. 194;
Western Union v. *Kansas*, 216 U. S. 1;
Delaware, Lackawanna, etc., Co. v. *Pa.*, 198 U. S. 341;
Dewey v. *Des Moines*, 173 U. S. 193.

An income tax is no exception to this rule. Strictly speaking, income as such has no real separate existence. It is merely an attribute either of the recipient or of the source. An income tax must be either a tax on the recipient of the income or on the source of the income. And from a constitutional standpoint the validity of an income tax depends primarily on jurisdiction over either one or the other of these subjects of taxation.

This was directly held by this Court in *Cleveland, etc., Co.* v. *Pa.* (State Tax on Foreign Held Bonds), *supra*, where the Court held a Pennsylvania income tax attempted to be imposed against foreign holders of the bonds of a Pennsylvania corporation was invalid, because lacking in jurisdiction over a taxable subject.

This case has not been overruled and has been much cited. The *ratio decidendi* of *Alpha Portland Cement Co.* v. *Massachusetts*, 268 U. S. 203, is in conformity with this rule. In that case the tax was in two distinct parts,—one on a portion of income, and the other a tax on what was called corporate excess. The tax was attacked on the ground that there was no jurisdiction in the State to tax either. The Court considered the tax as an excise for the doing of business, and held it unconstitutional. But it is well settled that in passing on the constitutionality of a state tax, this Court will disregard matters of definition or form. If in that case there had been jurisdiction to tax the income, that portion of the tax would have been sustained, regardless of whether it was defined as an excise or an income tax. *Shaffer* v. *Carter*, 252 U. S. 37.

We repeat that the tax here in question is not a franchise or privilege tax measured by income but is a direct income tax (*supra* fn. 7, 20). There is therefore not here involved the question discussed in *Educational Films Corporation* v. *Ward*, decided by this Court January 12, 1931 and not yet reported, of the distinction between the subject and the measure of a tax. It seems clear that in this case if there is a lack of jurisdiction to tax the income directly, the tax cannot be sustained as upon some other subject with the exempt income used merely as a measure.

In the case at bar North Carolina has no jurisdiction over the person of the appellant, a New York corpora-

tion. It cannot lawfully tax it on its entire income regardless of its source. This is clear both by reason and by authority. For example, in *St. Louis* v. *Ferry Co.*, 11 Wall. 423, at page 430, this Court said:

> "Where there is jurisdiction neither as to person nor property, the imposition of a tax would be *ultra vires* and void. If the legislature of a State should enact that the citizens or property of another State or country should be taxed in the same manner as the persons and property within its own limits and subject to its authority, or in any other manner whatsoever, such a law would be as much a nullity as if in conflict with the most explicit constitutional inhibition. Jurisdiction is as necessary to valid legislative as to valid judicial action."

If it be assumed that North Carolina had the power to impose an income tax on the entire income of a foreign corporation, the result would lead to an absurdity that would prove the assumption fallacious.

If North Carolina could impose a tax on the entire income of a corporation, doing business in each of the forty-eight States of the Union, so could each of the other States. If we assume an income tax rate of 5%, that would mean that the forty-eight States could impose an income tax aggregating 240% of the corporation's total net income. That the law would not tolerate any such absurd result is obvious. The State cannot lawfully tax a foreign corporation on its entire income, regardless of the amount of income having its source in the taxing State. This limitation was recognized by the Legislature in enacting the statute in question. Under that statute a domestic corporation is taxed on its entire income; a foreign corporation only upon an allocated portion.

Since, then, the State cannot lawfully tax all of the income of a foreign corporation in every case, what is the limit of the State's power and the State's jurisdiction?

In the case of a resident and citizen of the State, the State can tax all of the income regardless of its source as the statute in question does to the citizens and corporations of North Carolina; but if it cannot tax all of the income of a non-resident, it seems clear that the limit of its jurisdiction is to tax that part of the income which has its source in the taxing State. The State has jurisdiction to tax the source, and, therefore, can properly tax the income flowing from that source. That was the point of the decisions in *Shaffer* v. *Carter*, 252 U. S. 37, and *The Yale & Towne Mfg. Co.* v. *Travis*, 252 U. S. 60. In those cases the power of the State to impose an income tax upon a non-resident at all was challenged upon the ground that an income tax was ordinarily a personal tax, and that as the State had no jurisdiction to impose a personal tax against a non-resident, it could not impose an income tax upon him at all. But the Court held that in so far as the income was derived from sources within the State, the State had the power to tax the source; and since it had the power to tax the source, it could properly tax the fruit—that is, the income. It is a necessary corollary of that case that the jurisdiction of the State of North Carolina in the case at bar to tax the appellant's income is limited to a tax on that part of the income having its source in North Carolina.

The appellant concedes that taxation is not an exact science, and that in the case of corporations doing business in many States an allocation of net income as to source with mathematical accuracy is impracticable and is not required. In such cases the constitutional rule is satisfied if the statute establishes a rule of allocation

which reaches an approximately true result. If the statute prescribes a rule of allocation, on the other hand, which is arbitrary and which is likely frequently to produce incorrect and false results, then the statute is unconstitutional and void as to a corporation which is in fact unjustly taxed.

Gast Realty Co. v. *Schneider Granite Co.*, 240 U. S. 55, 59.

That is the question in this case. Is the method of allocation of income provided in the statute a reasonable one naturally producing an approximately correct allocation of income according to its source, or an arbitrary rule which disregards realities and imposes a tax on subjects beyond the State's jurisdiction? The unjust result in the case at bar is persuasive evidence of the arbitrary character of the statutory allocation. If a consideration of the statute shows that unjust results are likely to follow in other cases, then the unjust result in the case at bar clearly entitles appellant to relief.

We correct one misapprehension of the State Supreme Court as expressed in its opinion. It says "The petitioning taxpayer, apparently conceding in its brief that the statute is constitutional upon its face, contends that the execution thereof and the application thereof to its business works out an unreasonable and highly arbitrary result and thus effects a denial of its constitutional rights" (R. p. 162). Appellant's concession was not that the statute was constitutional but that it could not be heard to question the constitutionality without showing that the statute worked an unreasonable result as to it.

The statutory rule of allocation is simple. It directs that income shall be allocated in proportion to the location of tangible assets owned. It expressly excludes from

the equation and from the allocation any consideration of receivables, stocks, or bonds, or other intangible assets. It excludes from consideration tangible property used but rented and not owned. It excludes from the calculation any consideration of the character of the business transacted or of the actual sources of income. The appellant says that that rule is arbitrary and as to it invalid. The question of the reasonableness of this basis of allocation has not been finally decided by the courts. It has only been directly considered in one case.

In *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, a Connecticut tax statute was challenged in which the rule of allocation was the same as the North Carolina statute here involved. It appeared in that case that the plaintiff's factories were located in Connecticut, and that all of its manufacturing was done in that State, while most of its selling was done outside of Connecticut. Forty-seven per cent. of its tangible assets were located in Connecticut, and fifty-three per cent. outside of Connecticut, so that Connecticut allocated to the corporation forty-seven per cent. of its net income. The corporation made no attempt to analyze its business and to show what in fact was the income having its source in Connecticut in its manufacturing operations, and what in its selling business outside of Connecticut. In its brief and argument the Underwood Company contended that its income flowed exclusively from its sales, and that the manufacturing business conducted by it could have no relation whatever to its income or profits. This contention was made *a priori* and with no analysis of the business. In deciding the case the Court held that the record failed to show that in fact less than forty-seven per cent. of the corporation's income was fairly attributable to the manufacturing business in the State, and since the appellant

in that case had failed to show that it was unfairly taxed, it was not in a position to raise the question as to whether or not the method of allocation of income provided in the statute was a reasonable and proper one.

The Connecticut statute there considered differed in one respect from that here under consideration. As the Court pointed out (p. 117) that tax was in lieu of all other taxes on corporations except the general property tax. Here the tax is strictly an income tax and is in addition to franchise and other taxes.

In addition to this case, the New York franchise tax law, which uses the location of tangible property as one of the factors in allocating income, has been several times considered. In *Alpha Portland Cement Co.* v. *Knapp*, 230 N. Y. 48, 231 N. Y. 516 (certiorari denied, 256 U. S. 702), the New York statute allocated income in accordance with the location of property and of the location of business transacted. But in connection with the allocation of property, investments in the stock of other corporations were limited to ten per cent. of the tangible property of the corporation. This limitation was attacked as unreasonable and unconstitutional, the Alpha Company showing that it had investments in the stock of foreign corporations, and that under the New York rule ninety per cent. of the value of the stocks was excluded from the allocation of assets, while the income from all stocks was included in apportionable income. It also owned bonds outside the State of New York. Interest on the bonds was included in apportionable income, while the value of the bonds was excluded from the allocation of assets.

In the Connecticut statute, as under the North Carolina statute, investments in the stock of other corporations were entirely excluded from the allocation. Under the

New York statute they were limited to ten per cent. of the tangible property. The New York Court of Appeals held the statute arbitrary and unreasonable, and that in the case of the Alpha Portland Cement Company it resulted in an unconstitutional taxing of property beyond the jurisdiction of the State.

In the majority opinion Judge CARDOZO said at page 58:

> "I am unable to avoid the conclusion that a method of apportionment which purposely ignores realities, which compels an assessor to look to some of the assets only and close his eyes to all the others, is arbitrary and unreasonable in its increase of the local burden."

On a motion by the State for reargument before the New York State Court of Appeals, the decision of this Court in the *Underwood* case was pressed as a reason for changing the original decision of the State Court; and in a supplementary opinion the New York Court of Appeals held that there was nothing in the *Underwood* case that conflicted with the decision of the New York Court (231 N. Y. 516). Thereafter the State of New York applied to this Court for a writ of certiorari, which was denied (256 U. S. 702).

In the case at bar we have shown (*supra*) that the appellant received dividends from the stock of corporations owned by it which had no relation to North Carolina and it also received interest on securities owned outside of North Carolina. The amount of these dividends and interest was included in the total net income of the appellant, so that eighty per cent. thereof was taxed by North Carolina. The value of the Company's investment in these stocks and interest-bearing securities, all of which are located outside of North Carolina, were entirely dis-

regarded in the allocation of assets. This was the precise situation in *Alpha Portland Cement Company* v. *Knapp*, (*supra*) and were the two grounds upon which the New York Court of Appeals held the New York tax invalid under the Federal Constitution. This is also the ground upon which this Court held the Oklahoma statute invalid in *Oklahoma* v. *Wells Fargo*, 223 U. S. 298. In that case this Court held it was unconstitutional to take into account valuable property situated outside of the State in order to increase proportionately the value of property within the State. It is true that in the case at bar the amount of income thus wrongfully subjected to tax is not large, but if the tax violates the constitutional guarantees this Court has settled that the amount of the illegal burden is immaterial. Thus in *Looney* v. *Crane*, 245 U. S. 178, the Court said:

> "It is thus manifest on the face of all of the cases that they in no way sustained the assumption that because a violation of the Constitution was not a large one it would be sanctioned, or that a mere opinion as to the degree of wrong which would arise if the Constitution were violated was treated as affording a measure of the duty of enforcing the Constitution."

In *Alpha Portland Cement Co.* v. *Massachusetts*, 268 U. S. 203, at page 218, the Court said:

> "The amount demanded is unimportant when there is no legitimate basis for the tax. So far as the language of Baltic Mining Co. *v.* Massachusetts, 231 U. S. 68, 87, tends to support a different view it conflicts with conclusions reached in later opinions and is now definitely disapproved."

The New York statute was also considered in *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U. S. 271.

The opinion in that case pointed out that the New York allocation of income was not upon the basis of location of tangible property alone, but included other factors. In affirming the judgment sustaining the tax this Court said at page 283:

> "It is not shown in the present case, any more than in the *Underwood* case, that this application of the statutory method of apportionment has produced an unreasonable result. The fact that the company may not have had any net income upon which it was subject to payment of income tax to the Federal Government obviously does not show that it received no net income from the business which it carried on in New York. There is no evidence in the record as to whether the company received any net income from its New York business, or the amount of the profit and loss on that business, if any, either considered separately or in connection with the manufacturing business carried on in Great Britain."

The same New York statute was also attacked in *Gorham Mfg. Co.* v. *Tax Commission*, 266 U. S. 265. The taxpayer in that case did not pursue the administrative remedies provided in the statute, but sued for an injunction in the United States District Court upon the ground that under the facts in that case the New York rule of allocation subjected to tax a greater amount of income than actually had its source in New York. This Court declined to consider this question on the record in that case, saying at page 269:

> "We are of the opinion, however, that, without reference to these constitutional questions, the bill was properly dismissed by the District Court because of the failure of the Company to avail itself

of the administrative remedy provided by the statute for the revision and correction of the tax."

These are the only cases in which the reasonableness of a statutory allocation of income has been considered by this Court for that question was not involved in the recent case of *Educational Films Corporation* v. *Ward* (*supra*). The *ratio decidendi* of these cases seems to indicate that an allocation of income upon a fixed statutory formula is invalid as applied to a taxpayer who shows that as to him the statute produces an unjust result. They certainly are not authority for saying that the statutory formula here in question is constitutional when construed to allocate eighty per cent. of income, and when the taxpayer shows that only seventeen per cent. of income had its source in the State. The most that the respondent can claim for these decisions is that in such case the constitutional question is an open one.

While it may be that the mere fact that in the case at bar eighty per cent. of the income was allocated under the statute, while in fact only seventeen per cent. of the income had its source in the State, does not without further facts or consideration establish the invalidity of the statute and the arbitrary nature of the allocation, it is at least persuasive evidence to that effect.

If the disregard of realities in the case of the appellant was caused by an exceptional combination of circumstances not reasonably to be anticipated, the statute might be good and the result merely the appellant's misfortune. But in the appellant's case the radically unfair results are not due to any unusual or extraordinary circumstances. The evidence shows that substantially similar results have occurred in each of the four years in question, and an analysis of the appellant's business shows

that these arbitrary and unfair results are the natural result of the statutory allocation. Under these circumstances, the fact that the statute taxes more than three times, and perhaps more than four times, as much income as actually has its source in the State is persuasive evidence as to the arbitrary character of the statutory allocation.

The appellant occupies and operates two factories—one in North Carolina and one in New York. It so happens that it owns the factory in North Carolina, and that it rents the factory in New York. So far as the source of income is concerned, it is clear that the incident of the character of occupation, whether of ownership in fee or an occupation as a tenant, does not affect the business transacted. If the appellant owned its New York factory and rented its North Carolina factory, the character of its business so far as North Carolina is concerned would remain unchanged. The difference would be merely that some one else would pay the real estate taxes assessed against the North Carolina property which the appellant in this case pays, and yet that casual incident under the statutory allocation makes a difference of more than fifty per cent. of the income tax that North Carolina has assessed against the appellant.

Its factory investment, as shown on the balance sheet in the record, in North Carolina amounts to over one million dollars. This is somewhat more than fifty per cent. of its total tangible assets. Roughly speaking, for a four-year period, the appellant had about two million dollars of tangible assets, which were allocated about $1,600,000 to North Carolina, and $400,000 outside of North Carolina. Now, if the appellant had rented this plant in Asheville, and had owned a plant of similar value in New York, under the statutory formula the Asheville assets would have decreased one million dollars, and the New

York assets would have been increased one million dollars. The resulting allocation would have been $600,000 to North Carolina, and $1,400,000 outside of North Carolina; and less than forty per cent. of the income would have been allocated on that basis to North Carolina.

The value of the factory which the appellant rents in New York is not shown in the record, and its actual value is immaterial. It could readily be equal in value to the value of the North Carolina tannery. The point is that whatever that value may be, because it is rented and not owned, it is excluded from the computation; and, similarly, if the North Carolina factory had been rented and not owned, it would have been excluded from the computation.

The record shows that the appellant holds certain bark lands of the value of $40,000 as a reserve of bark lands located in North Carolina. No bark or timber has been cut upon them, and no income received from them during any of the years in question (R. p. 111). They represent entirely a dead asset and have had nothing to do with the appellant's business. And yet under the statutory allocation these dead lands have a material influence on the amount of income which is allocated as having its source in North Carolina. If these reserve lands had been owned over the border in Tennessee, they would have operated to reduce the income allocated to North Carolina. Obviously, they have nothing to do with income in either event. Their inclusion as a controlling factor is wholly arbitrary.

This Court has defined income as "the gain produced from capital or labor or both combined." (*Eisner* v. *Macomber*, 252 U. S. 189, 207.) An allocation of income as to source to be a reasonably correct allocation must take account of the actual and ordinary sources of income.

Capital is ordinarily a productive source of income. If a statutory formula was broad enough to make a fair allocation of the ordinary business and took into account the ordinary sources of income, then the fact that one of the factors entering into the computation was the location of capital might not invalidate the apportionment, even though it was shown in an individual case that in fact a certain portion of that capital was not at a certain time producing income. But when the allocation is based *solely upon the location of capital*, and furthermore is limited, not to the location of all capital, but merely to the location of a certain particular kind of capital (that is, tangible assets as distinguished from intangible), then the arbitrary nature of the allocation becomes apparent; and the illustration that much of this capital is often non-income producing is evidence of the arbitrary character of the statutory rule.

It is apparent that in any manufacturing business the income or profit represents the gain from capital which is invested in varying proportions in tangible and intangible assets, and also from the labor expended by the employes of the corporation. The North Carolina rule wholly disregards the allocation of labor as entering into the production of income; and it wholly disregards the use of the capital invested in intangible assets, such as stocks, bonds, accounts receivable, etc.

The North Carolina statute expressly provides that the apportionable income of a foreign corporation includes not only income arising from the use of tangible property, but also interest and dividends—that is, income received from intangible property and from any other source whatever. The tax is levied on a proportion of the total income determined by the location of tangible property. In the case of foreign corporations, investments in stocks

and bonds would normally have no relation to the business in North Carolina. By disregarding the location of these investments in determining the proportion of total income to be taxed, and by including the income from these investments in the tax base, the statute in fact imposes a tax upon these investments which may be wholly without the State's jurisdiction. Often the income from such investments is very large, and may well be greater than the total income from manufacturing or merchandising. In the case at bar we have shown that a portion of the income here taxed was of this character.

The inevitably unjust and arbitrary character of the statutory rule of allocation based upon tangible assets alone appears in almost any hypothetical case. Thus, suppose a trading company that does no manufacturing, and which operates two stores, one in North Carolina and one in Tennessee. The profits of each store are separate and distinct and easily ascertainable. They depend, of course, primarily on the volume of business done and on the rate of profit. If the North Carolina store has made an unwise purchase of slow-selling goods, it will have on hand a large amount of tangible property and will have small profits. If the Tennessee store has bought popular goods, it will move its inventory quickly, will have on hand a small amount of tangible goods, and will have large profits. This is not an exceptional case, but is a common rule in commercial business. In such a case the profits are in inverse ratio to the location of tangible property.

In the case at bar the larger part of appellant's profits come from its retail sales in New York. These profits have no relation to the tangible property in North Carolina. There is a manufacturing business in North Carolina, and in New York a manufacturing business and a

retail merchandising business. Each is to a considerable extent independent of the other. The tangible property in one State has no direct connection with the profits in the other.

The fact is that in most businesses conducted in different places there is no necessary or direct ratio between the profits and the location of tangible assets. It is submitted that if in any case the two ratios are in fact similar, such relationship is wholly fortuitous and not at all causal.

Business experience establishes the fact that profits have no fixed or constant relation to capital, least of all to any particular kind of capital. There are many factors that enter into the ultimate result of business profit or net income. Two concerns in the same business and starting with the same capital will usually have widely different profit results. One prospers, and the other goes into bankruptcy. Obviously, capital is not the sole source of income. Still more is this the case if the comparison is limited to tangible capital. Any business concern, in addition to its fixed investment in tangibles, must have working capital represented by cash in bank, investments, and accounts receivable. A large fixed investment in plant with inadequate working capital is an indication of weakness, and not of strength. It is elementary that in the analysis of corporation reports from the investment standpoint, two factors are controlling: (1) the earning capacity or income, (2) the quick asset position, especially with reference to intangibles. The value of tangible assets is ordinarily accorded very little weight in an investment study.

The fact, then, that business experience shows that tangible capital has no uniform or fixed relation to income, and that investment experience shows that tangible capital is of relatively slight importance in determining

investment value, is further indication of the essentially arbitrary character of the North Carolina allocation.

No statutory allocation can be upheld against a taxpayer as to whom it works an unjust result unless the rule itself contains a necessary causal relation between the measure and the result. The mere fact that it may be fair in some cases is not enough. That would save it in the absence of showing an unjust result in the particular case, but that is all.

The tax statutes in question, in making the allocation, disregard the actual source of income and proceed according to a wholly arbitrary rule. The statutory rule has not only a tendency, but almost a certainty of creating inequality. It is well settled that rules of apportionment must be such as will result in substantial equality as between members of the same class.

Gast Realty Company v. *Schneider Granite Co.*, 240 U. S. 55;
Airway Corporation v. *Day*, 266 U. S. 71.

We submit that both upon reason and upon authority the North Carolina tax statute here in question is arbitrary and unreasonable and is not founded on reasonable probabilities. It taxes income without regard to its source and thus in the case of a foreign corporation it tends to tax income having its source outside of the jurisdiction of North Carolina. In the case at bar this tendency has ripened into actuality. Under the statutory rule of apportionment, four times as much income has been subjected to tax as has its source in the State of North Carolina. It is submitted that the statute is repugnant to the provisions of the Fourteenth Amendment to the Federal Constitution as arbitrarily depriving appellant of its property without due process of law.

POINT IV.

The North Carolina Revenue Acts of 1923 and 1925 as construed and applied to appellant are invalid and unconstitutional, because repugnant to the commerce clause of Section 8, Article I of the Constitution of the United States as involving a burden upon appellant's interstate commerce.

The argument that the tax is repugnant to the Commerce Clause of the Federal Constitution follows as a corollary from what has been said in the preceding point in connection with the due process clause of the Fourteenth Amendment.

It is well settled that a state cannot, under the Federal Constitution, lawfully impose a tax which is a direct burden on interstate commerce. This is so even when the State has personal jurisdiction over the taxpayer. It is upon this principle that taxes on gross receipts received in interstate commerce have been held invalid.

Crew Levick Co. v. *Penn.*, 245 U. S. 292;
Kansas City R. R. Co. v. *Botkin*, 240 U. S. 227;
U. S. Express Co. v. *Minnesota*, 223 U. S. 335;
Galveston Ry. Co. v. *Texas*, 210 U. S. 217.

It is also settled that where a state has personal jurisdiction over a taxpayer, it can lawfully assess an income tax against him measured by his entire net income, even though all or a large part of that income was derived from interstate commerce. This is true, because a tax on net income, where there is jurisdiction over the taxpayer, is considered to be so far removed from the inter-

state commerce that produces the gross income as not to constitute a burden on that commerce.

U. S. Glue Co. v. *Oak Creek*, 247 U. S. 321;
Peck & Co. v. *Lowe*, 247 U. S. 165.

But it follows that where there is no personal jurisdiction over the taxpayer, and jurisdiction to tax rests upon the business done, a tax on net income derived from interstate commerce is invalid under the Commerce Clause; and the fact that the tax is measured by net income and not by gross receipts does not save the tax, because in such case the subject taxed is interstate commerce, on which the tax is thus a direct burden.

Alpha Portland Cement Co. v. *Massachusetts*, 268 U. S. 203.

The general rule as to when a state tax is repugnant to the Commerce Clause has been covered by so many decisions of this Court that we venture to submit the following as a summary statement applicable to the facts in this case:

> *A state having the admitted power to impose a franchise tax on a foreign corporation can measure that tax in any proper or suitable way, as by a tax on the net income of the company derived from its business within a state. But in such cases there must be some reasonable relation between the measure of the tax and the subject taxed.*
>
> *A tax of a given per cent. of the entire net income of a foreign corporation doing both a local and interstate business in several States, although declared by the State imposing it to be merely a*

charge for the privilege of conducting a local business therein, is essentially and for every practical purpose a tax on the entire business of the corporation, including that which is interstate, and this because the entire net income of the corporation represents all its business of every class and wherever transacted. Such a tax is void because in disregard of the Commerce Clause.

International Paper Co. v. *Massachusetts*, 246 U. S. 135;
Looney v. *Crane*, 245 U. S. 178;
Fargo v. *Hart*, 193 U. S. 490;
Oklahoma v. *Wells Fargo Co.*, 223 U. S. 298;
Pollock v. *Farmers Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601.

In the case at bar appellant's evidence shows that in fact a large part of its income is directly derived from interstate commerce, and that most of its sales are made in interstate commerce (R. pp. 98, 101, 134). If the appellant's contentions in the foregoing points are well founded, and if the North Carolina rule in fact in its application to the particular facts of the appellant's business and as a matter of reasonable probability as to other corporations results in taxing a very much larger percentage of net income than has its source in the business done and property owned in North Carolina, the tax constitutes a direct burden on interstate commerce and is invalid under the Commerce Clause as well as under the due process clause of the Fourteenth Amendment.

POINT V.

The North Carolina Revenue Acts of 1923 and 1925 are invalid and unconstitutional, because repugnant to the Fourteenth Amendment to the Constitution of the United States in that they arbitrarily deprive appellant of equal protection of laws.

The North Carolina law here drawn in question makes a classification of foreign corporations which the appellant says is arbitrary under the equal protection clause of the Fourteenth Amendment.

Section 201 of the statute in question imposes an income tax on every foreign corporation doing business in the State equivalent to three per cent. in 1923 and four per cent. in 1925 of a proportion of its entire income to be determined according to the following rules:

> "(a) In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale or rental of real estate or from the manufacture, purchase, sale of, trading in, or use of tangible (personal) property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to the fair cash value of its entire real estate and tangible personal property then owned by it, with no deductions on account of incumbrances thereon.
>
> "(b) In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in

this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State."

It will be observed that the statute arbitrarily classifies corporations into two kinds. As to one, the tax is apportioned in accordance with the location of tangible property within and without the State, and in the other case the tax is apportioned in accordance with the gross receipts of the corporation within and without the State.

We are not here concerned with which of these two rules of apportionment is the fairer. It is probable that in the case of an ordinary business corporation a tax in proportion to gross receipts is much more likely to be a fair tax on the profits than a tax based upon the location of tangible property, which may or may not have any direct relation to production of income. But the point here raised is that the classification is in fact wholly arbitrary.

Let us assume two corporations. One is engaged in the purchase and sale of groceries; it operates a store in North Carolina; and it operates a store in Tennessee. The tax as to it is on that portion of the entire income that the value of the tangible property owned in North Carolina bears to its total tangible property. If it happens to own the store in North Carolina and to rent the store in Tennessee, the proportion of total income taxed to North Carolina is very large and is entirely irrespective of the volume of business transacted respectively at the two stores.

The other corporation is engaged in selling stocks and bonds. It also maintains a place of business in North

Carolina and in Tennessee; and in each State it is doing a local business, just as in the case of the grocery corporation. It also owns business premises in North Carolina, and it rents its premises in Tennessee. But the ownership of this property in North Carolina does not influence the imposition of a tax against it. As to it the tax is directly in proportion to the volume of business done at the two stores respectively. As to the corporation that is dealing in intangible property the tax is directly apportioned in accordance with the business done. As to the corporation that is dealing in tangible property the tax wholly disregards the volume of business done, and bases a tax wholly upon the chance or incident as to the location of property owned as distinct from property occupied or used in the business.

In previous points we have discussed the contention that the allocation of income in accordance with the location of tangible property is an arbitrary rule that inevitably tends to produce an unfair and incorrect result. Here we confine ourselves to pointing out that the classification in the statute with two entirely different methods of apportionment is also arbitrary and unreasonable, and that in the case of the appellant this arbitrary rule results in subjecting it to a vastly larger tax than it would have been subjected to if it had fallen under the classification of a corporation dealing in intangible property. The record shows that if the tax were apportioned on the basis of gross receipts, less than two per cent. of its income would be apportioned to the State of North Carolina. The appellant concedes that such an apportionment would be unduly favorable to it, but that is the apportionment that the statute provides for a large class of corporations, and the appellant submits that there is no valid

basis of classification in the difference and condition that justifies this radically different basis of determination of the income to be subjected to tax. The whole scheme of the statute based on this arbitrary classification is invalid, because repugnant to the equal protection clause of the Fourteenth Amendment.

The power of the Legislature to classify subjects of taxation is, of course, very wide, but it is not unlimited, and it cannot lawfully be exercised in an arbitrary or capricious way. *Royster Guano Co.* v. *Virginia*, 253 U. S. 412, 415. Where the Legislature attempts a classification which is founded on unreasonable recognition of differences in condition as affecting taxation, the law and the classification resulting therefrom is invalid. An arbitrary classification is repugnant to the Fourteenth Amendment as depriving a taxpayer, who is penalized by that classification, of the equal protection of the laws guaranteed to it under the Fourteenth Amendment. An extensive citation of authorities for this general rule is unnccessary. It is illustrated in four representative causes.

Gast Realty Co. v. *Schneider Granite Co.*, 240 U. S. 55.

Here was drawn the question of validity of an ordinance of the City of St. Louis, assessing the cost of paving a street against adjoining property owners. The assessment was directed to be based on length of the fronting land without providing for an equal depth of the assessment districts. The law was attacked and held invalid as depriving taxpayers of the equal protection of the laws in that the classification of taxpayers was arbitrary. The Court said at page 58:

> "But * * * if the law is of such a character that there is no reasonable presumption that substantial justice generally will be done, but the probability is that the parties will be taxed disproportionately to each other and to the benefit conferred, the law cannot stand against the complaint of one so taxed in fact."

Again the Court said:

> "The defendants' case is not an incidental result of a rule that as a whole and on the average may be expected to work well, but of an ordinance that is a farrago of irrational irregularities throughout. It is enough to say that the ordinance following the orders of the charter is bad upon its face as distributing a local tax in grossly unequal proportions not because of special considerations applicable to the parcels taxed but in blind obedience to a rule that requires the result. And it cannot be said that the ordinance as a whole may be regarded as an individual exception under a rule that promises justice in all ordinary cases."

In *Air-Way Elec. Corp.* v. *Day*, 266 U. S. 71, the Court held an Ohio statute bad as denying equal protection of the laws. It imposed a fixed tax per share upon corporations having stock of no par value. The Court held that the business and property of a corporation having stock of $100 a share par value did not differ essentially from a corporation having stock of no par value, but divided into shares having an asset value of perhaps $5.00 a share. The tax imposed upon the stock of no par value of a fixed amount and generally corresponding to the tax that would be imposed upon a corporation having shares of $100 par value and based entirely upon the num-

ber of shares of stock authorized was held repugnant to the Fourteenth Amendment.

In *Louisville Gas & Elec. Co.* v. *Coleman*, 277 U. S. 32, the Court considered the validity of a mortgage recording tax under the laws of Kentucky. A tax was placed on mortgages running for more than five years; mortgages for less than that term were exempted from the tax. The Court held that the classification was arbitrary, that it placed mortgagors who put mortgages for more than five years on their property at a disadvantage and inequality as compared with those who borrowed money for shorter periods, and condemned the law as invalid under the equal protection clause of the Fourteenth Amendment.

In *Quaker City Cab Co.* v. *Pennsylvania*, 277 U. S. 389, the Court held a statute of Pennsylvania, which levied a tax upon the total receipts of all corporations, domestic or foreign, engaged in transportation business within the State, unconstitutional, because it did not levy this tax upon individuals or partnerships similarly engaged in the transportation business. The Court said at page 400:

> "The equal protection clause does not detract from the right of the State justly to exert its taxing power or prevent it from adjusting its legislation to differences in situation or forbid classification in that connection, 'but it does require that the classification be not arbitrary but based on a real and substantial difference having a reasonable relation to the subject of the particular legislation.' Power Co. *v.* Saunders, 274 U. S. 490, 493."

POINT VI.

The judgment should be reversed.

Respectfully submitted,

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